

Implementation Guide
and Financial Reporting Guide
under
Government Accounting Standards
Board Statement 35
Prepared for the
Commonwealth of Massachusetts
Institutions of Higher Education

-by-

The Office of the State Comptroller

As of the Fiscal Year Ended June 30, 2001—

INITIAL EDITION

SUBJECT TO REVISION

Introduction

The purpose of this document is to provide guidance for the implementation of Government Accounting Standards Board, (“GASB”) Statements 34 and 35. The statements represent the most radical departure in financial reporting standards seen since governmental financial reporting began. **It is important to emphasize that Statements 34 and 35 will not effect the day-to-day bookkeeping activities of your entity. It is also important to realize that the statutory basis of accounting remains unchanged.** The uniform implementation of Statements 34 and 35 is necessary for comparability between the Commonwealth’s various colleges and universities and to streamline financial reporting for the Commonwealth as a whole.

A Word about GASB 33 and 36

Some of the more significant changes to Governmental Accounting are not part of GASB Statements 34 or 35. These changes have been largely overlooked in the face of the release of Statements 34 and 35. GASB Statement 33, *Accounting and Financial Reporting For Non-exchange Transactions*, released in December 1998, becomes effective in fiscal 2001. GASB Statement 36, *Recipient Reporting for Certain Shared Non-exchange Transactions*, recently amended that Statement and is effective at the same time. The statements describe when revenue should be recognized and primarily mandates the accrual method of accounting.

The segments of the statements that would affect schools are paragraphs 7c and d (description paragraphs), and paragraphs 19 through 25. Institutions of higher education are involved in *Government – mandated non-exchange transactions*. Prime examples of these types of transactions are the Commonwealth’s appropriation for the specific purpose of education and its ancillary costs. In these transactions, your institution should follow the guidelines in paragraph 19. The stipulation is that the Commonwealth has a liability to your school and your institution has a receivable for an appropriation once the annual budget has been engrossed. Schools are also involved in *voluntary non-exchange transactions* primarily represented by pledges and contributions, though the latter type of transactions would largely fall under the umbrella of your school’s private foundation (if applicable.) Please check with your external auditor to make sure you are following the guidelines properly.

For the Commonwealth’s institutions of higher education already following the National Association of Colleges and University Business Officer’s (“NACUBO”) model, the transition to Statements GASB 34 / 35 will require less change. Two changes however, are important. The first is the **Management’s Discussion and Analysis**, which becomes a required component of your financial reporting. This analysis details the results of the year’s operations in *laymen’s terms*. The second significant change is **the requirement that the school’s cash flows be prepared using the direct method instead of the indirect method widely employed in current financial reporting of institutions of higher education.**

This guide was designed with input from various officers to provide guidance to the institutions of higher education with the goal of uniform financial reporting under the new statement. We appreciate your continued support and involvement. If you have any issues, questions or comments, please feel free to contact us.

Continued

TECHNICAL INQUIRIES

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I. Implementation Calendar in the Commonwealth

The implementation of Statements 34 and 35 will require unprecedented coordination between the institutions of higher education and the Commonwealth. The deadline for implementation by the Commonwealth is fiscal 2002; therefore all institutions are required to implement GASB Statements 34 and 35 in fiscal 2002.

The Commonwealth will be converting the 2001 financial statements to the new format under GASB 34. Therefore, we advise that all institutions convert Fiscal 2001 Financial Statements over to GASB Statement 35 starting post audit. All that is needed is a high – level pro-forma set of Statement 34 / 35 financial statements **to be prepared from the fiscal 2001 statements for fiscal 2002. The purpose of this is to have available fairly stated beginning balances for the Statement of Cash Flows. Some of this information may be used in the Management’s Discussion and Analysis section as well.**

For a complete calendar see appendix A to this implementation guide. **Important dates that have been agreed upon between all parties are as follows:**

Date	Event
7/31/2000	Fiscal year 2001 Commonwealth budget passed.
11/15/2000	Estimates tentatively due to House Ways and Means and ANF fiscal affairs division (FAD) for FY 2002 budget – GASB 34 / 35 incremental costs should be included.
05/31/2001	Inventory of fixed assets should be completed involving DCAM, and all institutions of higher education.
7/2/2001 – 12/31/2001	Specific helpline to be staffed at the Comptroller’s office for component units and institutions of higher education to implement GASB 34 / 35.
8/1/2001	Transition to GASB 34 / 35 guidance released from Comptroller’s office.
10/15/2001	Higher Education FY 2001 Comprehensive Annual Financial Reports Due
10/15/2001 – 3/22/2002	Commonwealth / institutions of higher education to be working with their auditors to restate beginning balances for purposes of the Statement of Cash Flows and otherwise to conform to GASB 34 / 35. The Commonwealth’s Goal is to produce a “restated” 2001 CAFR by 3/22/2002.
10/30/2001	Commonwealth Statutory Basis Financial Report due.
12/31/2001	Commonwealth FY 2001 Comprehensive Annual Financial Reports Due – GASB 34 / 35 proforma financials included as supplementary information.
3/22/2002	Proforma institutions of higher education CAFR due to the Comptroller’s Office. <i>Earlier submission is encouraged.</i>
5/1/2002	GAAP packages mailed to institutions of higher education.
6/28/2002	End of FY 2002 – Fixed assets implementation.
7/2/2002 – 12/31/2002	Specific helpline to be staffed at the Comptroller’s office for component units and institutions of higher education for GASB 34 / 35.
10/15/2002	Commonwealth Statutory Basis Financial Report issued
12/31/2002	GASB 34 / 35 CAFR issued.

II. Management Discussion and Analysis

The first major requirement of GASB Statements 34 and 35 is the **Management Discussion and Analysis (“MD&A.”)** The purpose of an MD&A is a discussion, in laymen’s terms, of current year results in comparison with the prior year. As required supplemental information, (“RSI,”) the MD&A has procedures attached to it as part of the institution’s audit. Though, the work is streamlined only to include what is in Statement on Auditing Standards Number 52 (AU 558, paragraph 7). Additional work may be required upon the release of the AICPA State and Local Government Audit Guide, due in April 2001. Should you have questions on the audit of the MD&A, please feel free to talk to your external auditor. Though a comparison with the prior year is *not required* in Statements 34 and 35, certain calculations may need to be done to derive beginning balances for the revised format of the statement of cash flows, which is described later in this document. Some of this information may be useful to disclose in your MD&A.

a. What an MD&A isn’t

An MD&A *should not be confused with a transmittal letter*. A transmittal letter is a separate and distinct portion of the CAFR that is not audited. Paragraph 294 of GASB Statement 34 explains the Standards Board’s reasons why they have two different purposes.

b. What should be included in an MD&A

An MD&A is written from an objective point of view and it is audited as RSI. It should be easy to read, and describe what has happened during the course of the year **utilizing charts and graphs instead of long, verbose statements**. Included in the MD&A should be the following:

- A description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position (net assets) or results of operations (revenues, expenses, and other changes in net assets.)

This discussion should be based on events or decisions that *have already occurred, or have been enacted, adopted, agreed upon or contracted*. Schools should not discuss in the MD&A the *possible* effect of events that *might* happen (although such matters could be addressed in the letter of transmittal.) The award and acceptance of a major grant, the adjudication of a significant lawsuit, an approved increase in a university’s tuition and a renegotiated labor contract with government employees are just a few examples of facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations. On the other hand, predicting that an ERP system under construction “will pay for itself” over a certain period of time would be an example of a

statement that is *not* based on currently known facts, decisions, or conditions.¹ Other topics to be discussed may include:

- A short and long-term view of the government’s activities—‘where we are and where we are going.’
- A comparison of current year results with those of the prior year, with emphasis on the current year, **both positive and negative results**. This is a perfect place for charts and graphs.
- A focus on the school. Within that focus, discuss what is material. For those schools with component units, there should be a clear distinction between results from the primary school and those of the component unit entity.
- A discussion of only the most recent and relevant information – not “boilerplate” or information carried forward from the prior year.

Paragraph 11 in Statement 34 has an itemization of what should be included as a minimum. That information is included as an appendix to this guide.

Remember, because it is RSI, the MD & A has procedures of analysis in conjunction with the financial statements. Should your organization decide not to include the MD&A, or it differs materially from the rest of the audited financial statements, SAS 52 prescribes an explanatory paragraph required for inclusion in your audit opinion.² In order for the Commonwealth to maintain an unqualified opinion, your school should achieve the same.

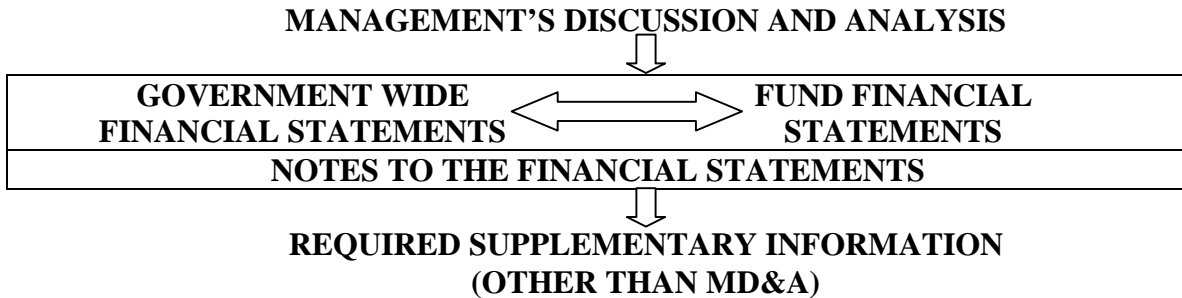
The authorship of the MD&A is important. To implement this Statement properly, the parties have agreed that the proper advice is that the management of your school and / or your staff write the MD&A and your external auditors perform their standard audit of that information.

¹ *Guide to Implementation of GASB Statement 34 on Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments – Page 4. Question 13.* Government Accounting Standards Board, 2000.

² Statement on Auditing Standards number 52, as codified in Section AU 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor – Submitted Documents*. December, 1980. Also referenced in Section AU 558, paragraph 8, *Required Supplementary Information*. April, 1988.

III. The Components of the Financial Statements

The components of the financial statements under GASB 34 / 35 are as follows:



Notice that the Letter of Transmittal and any statistics *are not* included in the “core” general-purpose financial statements.

For institutions of higher education in the Commonwealth there will be minor changes in comparison to other types of governmental entities. For a discussion on the entity –wide financial statements, please feel free to review Statement 34, paragraphs 12 through 17 and 30 through 90.

a. Components of Financial Statements for institutions of higher education

Per GASB statement 34 / 35, there are three required financial statements:

New Name	Old Name
Statement of Net Assets	Balance Sheet
Statement of Revenues, Expenses and Changes in Net Assets	Statement of Current Funds Revenues, Expenditures and Other Changes or – Statement of Changes in Fund Balances –
Statement of Cash Flows	Not a required presentation

b. Measurement and Focus of Revenues and Expenses

The focus and measurement of the revenues and expenses is the accrual basis of accounting. Revenues are recognized in the accounting period in which they are **earned and become measurable**. Expenses are recognized **in the period in which they are incurred, if measurable, including depreciation**.³

³ National Council on Governmental Accounting Statement 1 *Governmental Accounting and Financial Reporting Principles*. Principle 8b, paragraphs 57b and 60. March 1979.

c. Statement of Revenues, Expenses and Changes in Net Assets

This statement is a combination of your current statement of revenues and expenditures and your schools' statement of changes in fund balances. It is the operating statement for business – type activities, (“BTAs.”) The BTA format is what all parties in the Commonwealth and its auditors have agreed upon. Schools in the Commonwealth operate consistent with the definition of a Special Purpose Government engaged only in Business type activities as defined under GASB Statement 34. Furthermore, you are precluded from using the governmental format that the Commonwealth uses, unless your school has taxing authority.

The items below are in a “functional classification” format. All parties have agreed that this format should be used for your Statement of Revenues, Expenses and Changes in Net Assets. Functional classifications needed for IPEDS (Integrated Postsecondary Education Data System) and information gathering by the Board of Higher Education should be reported as a footnote.

The format of the statement is as follows. Please use the following accounts to classify your financial information. **Please note though that these items are illustrative only and are not authoritative.**

Operating Revenues

Student tuition and fees (net of scholarship allowances of \$xxx,xxx)⁴

Patient services (net of charity care of \$xxx,xxx)

Federal operating grants and contracts

State and local operating grants and contracts

Non-governmental grants and contracts

Sales and services of educational departments

Sales and services of public service activities

Auxiliary enterprises:

Residential life (net of scholarship allowances of \$xxx,xxx)

Bookstore (net of scholarship allowances of \$xxx,xxx)⁵

Subtotal of Operating Revenues

Operating Expenses

Instruction

Academic support

Student services

Public service

General administration

Operations and maintenance

⁴ **Note:** Tuition waivers could be construed as a contra-revenue to tuition. Paragraph 13.07 of the AICPA Not-For-Profit Organizations audit and accounting guide is unclear as to treatment. The paragraph states that if the school incurs an incremental expense in the waiver, then the waiver is an expense. If no expense occurs, the waiver is a discount. **Other financial aid should not be treated in this manner.**

⁵ If the school actually receives these revenues. Otherwise, if a separate dormitory authority or corporation runs these services, then any related payments or receipts such as rents and leases would be operational in nature.

Instructional support
Interest
Depreciation
College bookstore
Food service
Industrial training⁶

Subtotal of Operating Expenses

Total Operating Income (Loss)

Non-operating revenues and expenses

COMMONWEALTH OPERATING APPROPRIATIONS

Gifts

Investment income (net of investment expense – unless material – then present as a separate line)

Interest on capital – asset related debt

Other non-operating revenues

Other non-operating expenses

Income before other revenues, expenses, gains, losses and transfers

CAPITAL (not operating) contributions, additions to permanent endowments, special and extraordinary items and transfers

Commonwealth Capital appropriations

Capital grants and gifts

Additions to permanent endowments

Increase (decrease) in net assets

Net Assets – beginning of period

Net Assets – end of period

This is a model that is provided by NACUBO and GASB. Should your institution have any other material reporting categories, please contact us for proper reporting. Pursuant to GASB 9, operating appropriations from a primary government are considered **non-capital financing** cash flows and corresponding revenues to the higher education institution.⁷ A more thorough discussion on appropriations is below.

d. Statement of Net Assets – the New Balance Sheet

Statements 34 and 35 set up a new form of the balance sheet called the **Statement of Net Assets**. The basic accounting equation is as follows:

Statement Type	Accounting Equation
Old Type - Balance Sheet	Assets = Liabilities + Equity
New Type - Statement of Net Assets	Assets – Liabilities = Net Assets

⁶ Alternatively, your institution may present expenses in the “natural classification” format via a footnote. Those classifications include Salaries, Benefits, Scholarships and fellowships, Utilities, Supplies and other services, depreciation and other. We encourage your school to present this footnote.

⁷ Government Accounting Standards Board Statement 9, *Reporting Cash Flows of Proprietary and Non-expendable Trust Funds and Governmental Entities That Use Proprietary Accounting*. Paragraphs 20-22. December, 1989.

Statements 34 and 35 allows the use of *either a balance sheet type or a statement of net assets method for proprietary or business type activities* such as institutions of higher education. However, **institutions have agreed to align to the Statement of Net Assets format, so that we can combine the formats efficiently into the Commonwealth's financial statements.** The Statement of Net Assets format is the methodology preferred by NACUBO. The statement of net assets will also have to be *classified* by the segregation of current vs. non-current assets, liabilities and net assets.

A couple of notes about the implementation of the statement of net assets:

1. Eliminating entries should be made in the statement of net assets to minimize the “grossing up” effect on assets and liabilities.
2. Internal “Due to’s” and “Due from’s” should also be eliminated. External due to’s and from’s should still be included and should be reported as external transactions, effecting revenue and expense.⁸

What is the difference between current and non-current assets and liabilities?

A current asset or liability is available to be liquidated readily. It has a life of one year or less, or it is one that would be satisfied within the current “cash to cash” cycle. Your statement of net assets must be classified current and non-current in order to comply with Statements 34 and 35. Non-current assets or liabilities are items that will not be satisfied within one year, or one “cash to cash” cycle.

The following are certain classifications of current and non-current items:

Current	Non-Current
Assets	
Cash and cash equivalents	Restricted cash and cash equivalents
Short – term investments	Endowment investments
Accounts receivable, net	Notes, student loans and mortgages receivable, net (over 1 year)
Inventories	Other long – term investments
Deposits	Investments in Real Estate
Notes, student loans and mortgages receivable, net (within 1 year)	Fixed Assets – Land, Buildings, Equipment, Infrastructure, Historical Treasures and artwork net of accumulated depreciation (if applicable)
	Other non-capital assets (e.g. patents etc.)
Liabilities	
Accounts payable and accrued liabilities	Deposits

⁸ Statement 34, Paragraphs 59-61.

Deferred Revenues	Long-term Deferred Revenues
Current portion of long term liabilities, bonds, leases, loans and notes (within 1 year)	Long-term portion of long term liabilities, bonds, leases, loans and notes (greater than 1 year)
Claims and Judgements – Current portion	Claims and Judgements – Long Term portion
Current compensated absences and pensions	Long Term compensated absences and pensions

There may be variants of each category, prime examples being cash related to bond proceeds, cash in reserve funds etc. Please discuss with your external auditor as to these categories' placement as current or non-current.

What are the components of Net Assets and how should they be presented?

The display of net assets should be in three components:

Invested in Capital Assets, net of related debt
 Restricted Net Assets – distinguished between major categories of net assets
 (Includes permanent endowments – **these should be further segregated by expendable and non-expendable.**)
 Unrestricted Net Assets

These components are analogous to what used to be called “fund balance.”

Invested in capital assets, net of related debt

The new category, “Invested in capital assets, net of *related* debt” is a new calculation that will have to be presented in the footnotes, showing how the number was derived. The calculation is as follows:

Cost of Capital Assets Acquired	\$x,xxx,xxx
Less: Accumulated Depreciation	xxx,xxx
Less: Outstanding Debt Related to Capital Assets	<u>x,xxx,xxx</u>
Invested in Capital Assets, Net of Related Debt	<u>\$x,xxx,xxx</u>

This number could potentially report a negative net asset or a net asset of zero. This is due to the fact that debt that is outstanding may exceed the depreciated value of its related assets. In order to obtain this net asset balance, a complete analysis will need to be done, linking your assets to the debt issued to finance them.

If there are unexpended debt proceeds at year-end, the portion of the debt attributable to these proceeds, cannot be counted in the net assets line, “Invested in capital assets, net of related debt.” It should instead be reported **as net assets restricted for capital projects.**

Restricted Net Assets

As indicated above, there could be timing issues that restrict capital assets. Restricted net assets are usually assets limited to designated purposes as per donor or grantor request. Restricted net assets could be expendable or non-expendable. In addition, restriction could likely occur due to creditor or legislative issues. Certain items in the list below may also not be limited to purpose by donor or grantor request. Therefore, some of these may be improperly classified. Each has to be individually evaluated. In higher education, common restrictions may be the following:

- Nonexpendable funds for scholarships, fellowships and research
- Expendable funds for scholarships, fellowships, research
- Instructional department uses
- Loans
- Capital projects (including unexpended debt proceeds)
- Debt Service
- Other

In summation, restricted net assets, as defined in paragraph 34 of Statement 34, should be reported when constraints placed on net asset use are either:

- a. Externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments
- b. Imposed by law through constitutional provisions or enabling legislation.

The basic concept is that restrictions are not unilaterally established by the reporting government itself, and cannot be removed without the consent of those imposing the restrictions or through formal due process.

The definition of *restricted* in paragraph 34 is intended to identify resources that were received or earned by the government with an explicit understanding between the government and the resource providers that the funds would be used for a specific purpose. For example, grants, contributions, and donations are often given under those kinds of conditions. Bond indentures similarly limit the use of proceeds. Therefore, bond proceeds are typically also restricted.⁹

Unrestricted Net Assets are therefore, anything that is left over. Unrestricted net assets are inherently the repository for anything that would otherwise be restricted. The amounts in this category cannot be invested in capital assets, or not restricted in other fashion.

Pell Grant Activity – Pell grant activity is currently reported in restricted current funds. Due to GASB 35's repeal of GASB 19, Pell grants should be now reported as agency transactions, similar to the treatment in FASB 116 and 117. Please check with your external auditor for proper accounting treatment.

⁹ *Implementation Guide*, Question 95.

IV. Direct Method Statement of Cash Flows – Components and Crosswalks

Producing a Statement of Cash Flows may be a new statement for an institution of higher education. If your school has an enterprise fund, or other business-type activity, chances are a statement of cash flows was prepared in previously issued financial statements.

GASB 34 requires the **direct method** of preparing cash flow statements for business-type activities. Under the **direct method**, cash receipts and disbursements for the fiscal year are determined. The indirect method, which is more widely used, adjusts net income for items the affected reported net income, but did not affect cash. The calculations in the indirect method are largely performed by analyzing changes in balance sheet accounts. The difference between the two methods only affects the **net cash flow from operating activities**.

There are four required classifications of cash flow:

1. Operating Activities
2. Noncapital Financing Activities
3. Capital and Related Financing Activities
4. Investing Activities

a. Operating Activity Cash Flows

To create the operating activities section of the statement of cash flows, accrual data must be converted into “cash basis.” A reconciliation of this conversion must be presented at the bottom of the statement. Inflows of cash are aggregated by major type and outflows are reported by payment type.

We have agreed that the following is to be our policy of what are inflows and outflows. **Though these are illustrative and non-authoritative, please adhere to these categories, as deviation will only cause confusion when aggregated into the Commonwealth’s financial statements.**

Continued

OPERATING ACTIVITIES	
INFLOWS	OUTFLOWS
Cash received from Customers (may be directly named in the following categories, if material:) <ul style="list-style-type: none"> Tuition and fees Auxiliary Revenues – Tolls, fares, rents, residence hall fees, cafeteria, day care, parking, ticket sales to events, Continuing Education. Research Contracts and Grants Federal Operational Appropriations Reimbursement Receipts Perkins and faculty, student and staff loan payments Unrestricted gift receipts that do not finance capital projects Other operating cash inflows 	Cash payments to (should be directly named in the following categories:) <ul style="list-style-type: none"> Payments to Employees Payments of Employee Benefits Payments to Vendors and Suppliers – includes utilities, contractors, books, food, vendors, operating leases. Loans to faculty, staff and students Scholarships and fellowships Other operating cash outflows Tuition remitted to the Commonwealth.

Loans issued to students and employees and Loan repayments from them should not be netted. Payments of scholarships and fellowships should also be shown separately.

b. Non-Capital Financing Cash Flow

By far the most controversial portion of the Statement of Cash Flows is the placement of **State Operating Appropriations** under Non-Capital Financing cash flow and not operations. NACUBO has agreed with GASB on the placement. GASB Statement 9, paragraphs 20 and 21, include proceeds from all borrowings not clearly attributable to construction, acquisition or improvement of capital assets also in this category. Specifically, paragraph 21 states:

Cash inflows from noncapital financing activities include:

- Proceeds from issuing bonds, notes and other short- or long-term borrowing not clearly attributable to acquisition, construction, or improvement of capital assets (*emphasis added.*)
- Cash receipts from grants or subsidies except (1) those specifically restricted for capital purposes and (2) those for specific activities that are considered to be operating activities of the grantor government.
- Cash received from other funds except (1) those amounts that are clearly attributable to acquisition, construction, or improvement of capital assets, (2) quasi-external operating transactions, and (3) reimbursement for operating transactions.
- Cash received from property and other taxes collected for the governmental enterprise and not specifically restricted for capital purposes. (e.g. PILOT payments made to governments.)

Cash outflows would largely mirror the inflows named in a to d above.¹⁰ The Commonwealth's yearly appropriations for higher education would probably be classified under item 'b' above. Item c would rarely occur in an institution of higher education in the Commonwealth. The only possibility would be if an entity such as the MBTA paid for a portion of a school's operations in some way, shape, or form. An example of item d would be any PILOT payments to a community made by a school.

c. Financing Activities Cash Flow

Financing activity cash flow is mainly derived from funds received and expended for construction and acquisition of capital assets. The inflows include funds from debt issuance, capital appropriations, capital grants and gifts received that are connected with capital activity. The outflows are funds used for purchases of capital assets, principal payments on capital debt and leases, interest paid on capital debt and leases and deposits with third party trustees for escrows (*not reserve funds.*)

d. Investing Activities Cash Flow

Investing activities are straightforward. These activities include purchases and sales of all investments and the interest earned thereon. These investing activities **include purchases and sales of reserve funds related to bond transactions.**

From these four categories, your school should easily be able to determine the net increase or decrease in cash for the year. Using the direct method, however, a further reconciliation is required, which equates operating income or loss to net cash provided by (or used in) operating activities. A simple equation is as follows:

Operating Income (loss)	\$xxx,xxx
Adjustments to reconcile net income (loss) to net cash	
Provided by (used in) operating activities:	
Depreciation and amortization expense	
Changes in assets and liabilities:	
Receivables – net	
Inventories	
Other Assets	
Accounts Payable	
Deferred Revenue	
Deposits held for others	
Compensated absences	
Loans to students and employees	<u>xxx,xxx</u>

Net Cash provided by (used in) operating activities \$xxx,xxx

For those who have done an indirect method of presentation of cash flows, the above reconciliation is the operating section of the statement. In the appendix to this

¹⁰ Statement 9, Paragraphs 20-22.

guide, a translation of a statement of cash flows from an indirect method to a direct method is included. We also encourage you to work with your outside auditing firm to gain any further understanding of the preparation of the statement.

Continued

V. Capitalization of Fixed (Capital) Assets, Uniform Capitalization Policy, Infrastructure and Depreciation

By far the most controversial element of Statements 34 and 35 is the presentation of fixed assets including infrastructure and their direct relationship to debt. For most institutions of higher education, the financial statement transition to compliance with Statement 34 and 35 *is relatively minor*, as your statements already include fixed assets and depreciation.

All infrastructure, historical treasures and works of art are now required to be “recorded” at the very least for insurance purposes. We have agreed that it is the policy of the Commonwealth not to capitalize and depreciate historical treasures and works of art, but you still have to account for their upkeep. *Capital assets are clearly defined in MMARS Memo #290.*

a. Where do I get information regarding the historical cost of infrastructure and fixed assets?

The Commonwealth recognizes that all schools have fixed asset records, but only the Community Colleges are depreciating those assets. We ask you to ensure that all fixed assets are included in your audits. Commonwealth policy requires fixed (capital) assets to be recorded at historical cost. Where historical cost is unavailable after a thorough search of bond documents, capital appropriations, donor records, etc., a current replacement cost estimate can be used. Paragraphs 157 through 160 of the statement allow a deflation of replacement cost to historical cost using commonly available indices. **Please contact the Office of the State Comptroller if you need assistance in arriving at historical cost.**

The Commonwealth, in conjunction with the Massachusetts Highway Department, the Metropolitan District Commission and the Department of Environmental Management is in the process of formulating policies and values for horizontal infrastructure. For vertical or movable assets, the Division of Capital Asset Management, or the Massachusetts Health and Educational Facilities Authority may be a source of information.

b. What are Historical Treasures and Works of Art?

Statement 34 does not clearly define a historical treasure. **We have agreed that it is our policy that a historical treasure is an asset that is not depreciable. It may be registered as an historical landmark, place, building, monument, etc.**

Works of Art are defined in two classes, those held for exhibition *and exhaustible* and those that are not. Works of Art that are **held for exhibition, education or research, those that are protected, cared for and preserved and those that, if sold,**

the proceeds must be used to acquire other artwork, are not accounted for as fixed assets and therefore **are not** depreciated. Works of Art that are deemed *exhaustible*, irrespective of their exhibition, need to be depreciated, but their cost or donor value should be reported on the books of the school. **We have all agreed that it is our policy that historical treasures and works of art in the Commonwealth will most likely not be depreciated, but their upkeep must be recorded as an expenditure.**

c. What are the categories of fixed (capital) assets for the Commonwealth?

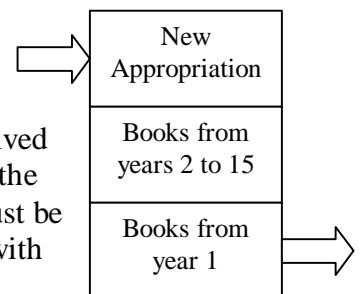
The following eight categories should be used, allowing for easy comparability between schools and other component units:

Not Depreciated -	Land Construction in Progress
Depreciable	Land Improvements Buildings Machinery, Equipment and Vehicles (including computers) Infrastructure Other

Your school has the opportunity to add additional, material categories if needed.

Depreciating Library Books and Software

An alternative method of accounting for library books is similar to the manner in which the University of Massachusetts effectively depreciates its books. The University receives a yearly appropriation for new books. The library then removes the amount received **fifteen years prior** to this year's appropriation, effectively depreciating the new books over 15 years. This method is acceptable, but the method must be disclosed in the institution's footnotes to its financial statements, along with the school's other capitalization policies.



d. Uniform Capitalization Policy

It is our goal to have a uniform capitalization policy for GAAP purposes. For *internal reporting purposes*, your school can continue to report in the manner approved by your Board of Trustees or the Board of Higher Education.

MMARS memo #290 states the following about the Commonwealth's capitalization policy:

- Departments are required to properly account for all fixed asset transactions. This includes the proper recording of and reconciliation of a periodic inventory of their Non-GAAP Fixed Assets. This physical reconciliation

- should be completed as of June 30th of each fiscal year.

- **Non-GAAP Fixed Assets**

Non-GAAP fixed assets are buildings and equipment, including computer software, with a useful life of more than 1 year and an original cost between \$1,000 and \$14,999.99, and all electronic and computer components. All Non-GAAP assets must be recorded, at the time of acquisition or disposal, in the Fixed Asset Subsystem of MMARS or in a system housed and maintained by the department. This is a minimum requirement.

- **GAAP Fixed Assets**

The requirements for GAAP Fixed Assets remain unchanged. GAAP fixed assets are defined as all land regardless of cost, buildings and equipment, including computer software, with a useful life of one year or more, and an original cost of \$15,000 or more. This includes **Construction in Progress** that will result in equipment, buildings or computer software that meet this cost criteria. **All GAAP fixed assets must be recorded, at the time of acquisition in the Fixed Asset Subsystem of MMARS.**

- **Other Commonwealth Assets**

Due to the nature of Department business, other governmental entity requirements, sound internal controls, etc. the department should determine if a lower threshold for the inventory of other Commonwealth assets under its control is appropriate. Assets acquired through Tax Exempt Lease Purchase (TELP) and capital leases are considered fixed assets at the time of acquisition.¹¹

Currently, MMARS Memo #290 does not address infrastructure. After consulting with our external auditors, it is entirely permissible to have *two different* capitalization levels for fixed assets. One is for “vertical” or movable fixed assets and the other would be for infrastructure.

We have agreed to continue the policies of capitalization, but want to have a goal of uniform alignment. GASB 34 / 35 is a perfect time to do this. The *current* policies are as follows:

	University System	State Colleges	Community Colleges
Land	All land	All land	All land
Library Collections	5 year amortization	5 year amortization	5 year amortization
All other assets	≥\$1,000 per unit	≥\$1,000 per unit	≥ \$15,000 per unit

For purposes of compliance with the Office of Management and Budget (OMB) Circular A-21, you may continue to use \$5,000 as your capitalization threshold, but be aware that this circular is currently under review.

¹¹ MMARS Memo 290, *Guidance on Non GAAP Fixed Asset Management MMARS*, June 30, 1999.

e. Depreciation and Asset Lives

The Commonwealth's current asset life policy is put forth in the procurement handbook, released by the Operational Services Division (OSD.) A table is set forth for **vertical and movable fixed assets** in the appendix to this guide. OSD's table is built off of Internal Revenue Service Publication 946, whose table B-1 is also included in the appendix to this guide.

A reminder – for cost recovery purposes, OMB Circular A-21 requires that depreciation methods for cost recovery must be the same as for financial statement purposes. Therefore, please adhere to the policy outlined herein.

In short, all items that are capitalized and are depreciable should be depreciated. **It is our policy to only use the straight-line depreciation method.** It is easy to understand and is rational in its basis.

Various asset lives as published by OSD are as follows:

Buildings	27.5 to 40 years, depending on construction
Building Improvements	20 years
Leasehold Improvements	5 years or the term of the lease, whichever is greater
Equipment (Non-Office)	10 years
Computer Equipment	3 years
Other Office Equipment	5 years
Life safety improvements	5 years
Motor vehicles	5 years
Used motor vehicles	3 years
Residential furnishings	3 years
Office furnishings	7 years

Other items from IRS 946 that you may have (not including infrastructure) are:

Land Improvements	20 years
Industrial Steam and Electric generation and distribution systems	22 years
Aircraft	6 years
Watercraft	20 years
Buses	9 years

The Massachusetts Turnpike Authority and the Massachusetts Port Authority (Massport) are the sources of the Commonwealth's policy on depreciating infrastructure. **For infrastructure depreciation, the following amounts useful lives will be used:**

Roads and Other Horizontal Infrastructure	50 Years (Note that Massport depreciates the Mystic – Tobin bridge at 100 years)
Port facilities – buildings and piers	25 years

Remember that depreciation is an estimate. If an asset **is sold, retired or lost due to a casualty before its useful life has ended, you must declare the disposition and record any gains or losses under GAAP.** In any such transaction, all accumulated depreciation to the date of the action must be removed.¹² As we go forward into implementing GASB 34 and 35, the Commonwealth will update its “Fixed Assets Subsystem Policy Manual and User Guide” to conform with all policies as applicable. The guide provides a far more detailed discussion of fixed assets and depreciation than this guide has.

Continued

¹² GASB 34, Paragraph 117 and Note 1, *Illustrative Disclosure of Information about Capital Assets* on page 245.

VI. Business-Type Activity Reporting – The Accrual Basis and Segment Reporting

Business – Type Activity, (BTA,) Reporting or reporting on the proprietary basis of accounting is not new to institutions of higher education in the Commonwealth. Since GASB Statement 20 was released, schools have used the proprietary basis of accounting. Because of this familiarity, the transition and implementation of GASB 34 and 35 should not be difficult.

The following statements will be required from your school in the implementation, all of which are described in section III to this guide:

- Management’s Discussion and Analysis – (Required Supplementary Information)
- Statement of Net Assets or a traditional Balance Sheet
- Statement of Revenues, Expenses and Changes in Net Assets (*note name changes*)
- Direct Method Statement of Cash Flows
- Notes to the Financial Statements
- Required Supplementary or Statistical Information other than the MD & A

The Comptroller in conjunction with the institutions of higher education have agreed that institutions are required to implement the Business-Type model due to the following factors:

- The BTA model is the model that best relates the financial condition of the school as the flow of funds is based on the accrual basis of accounting.
- Lack of taxing authority directly by the institutions of higher education.

The BTA format is the format that the Commonwealth and its auditors have agreed upon. Schools in the Commonwealth operate consistent with the definition of a Special Purpose Government engaged only in business type activities. Furthermore, you are precluded from using the governmental format that the Commonwealth uses, unless your school has taxing authority.

a. The Accrual Basis of Accounting and GASB 33

The business – type model uses the accrual basis of accounting. It should be noted that GASB Statement 33, *Accounting and Financial Reporting for Nonexchange Transactions* has somewhat modified the accrual basis of accounting for governments.

The accrual basis of accounting recognizes revenues when they are earned *and* measurable and expenses in the period incurred, if measurable. This method is similar to that in use in the private sector. Therefore, receipts and disbursements are recorded throughout the year. Those receipts that are earned as of June 30, but not yet received are revenue and receivables. Those expenses that are incurred, but not yet paid as of June 30,

are recognized as expenses and payables. As stipulated in section IV to this guide, receivables and payables should be further classified as current and non-current.

Special care must be exercised when recognizing when gifts are receivable under GASB 33. These rules may or may not apply to your institution, as your school may have a private foundation that accepts all donations. Should your school accept gifts directly, the guidance for donations is discussed in paragraphs 21 through 25 of Statement 33. Schools should recognize revenue (and therefore, a receivable) when resources are received and all eligibility requirements to the donation are met. If the gift has a restricted use, then the revenue and responding change in net assets are also restricted. Assuming all eligibility requirements are met, a pledge would be recorded as follows:

Pledge Made from Donor:

Dr. Pledges receivable
 Cr. Allowance for un-collectable pledges
 Cr. Pledge revenue

Cash received – 100% of pledge

Dr. Cash
Dr. Allowance for un-collectable pledges
 Cr. Pledges receivable
 Cr. Pledge revenue

Long-term pledges receivable may have to be discounted under Statement of Financial Accounting Standards Statement 116, paragraphs 8 and 20 – 21. It is currently unclear from the literature whether this falls under the scope of Statements 34 and 35.

b. Segment Reporting

Paragraphs 122 and 123 in GASB 34 report on segments. A segment is a “stand-alone” entity within which, “one or more revenue bonds or other revenue-backed debt instruments (such as certificates of participation) are outstanding. A segment has a specific, identifiable revenue stream pledged in support of revenue bonds or other revenue backed debt.”¹³ Segments may also have specific revenues, expenses, gains and losses, assets and liabilities. There are a few prime examples of segments within a college or university:

- Where a bond issue funded construction of a single student residence facility and the net revenues of the facility pay for the debt.
- Where a bond issue funded construction of four student residence facilities and the net revenues of **all four facilities pay for the debt**.

¹³ GASB 34, Paragraph 122.

- Where a bond issue funded construction of four out of eight student residence facilities and all eight facilities' net revenues are pledged to pay the debt.
- Where a series of notes funded construction of a parking garage and the net revenues of parking operations paid for the facility.

The following **are not grounds for segment reporting**:

- A short-term loan is secured for operations. All student fees are pledged to repay the loan.
- A statewide authority issued one bond issue for several revenue-backed projects, including the parking garage at the institution. The institution pledged to the authority the net revenue from the parking structure. The authority is obligated to the bondholders. There is **no segment for the institution, but there is a segment for the state authority**.
- A multi-campus system issues bonds covering three student residence facilities at three different campuses. The combined revenues from all three are pledged to pay the bonds. In the financial report that includes all three campuses, the campuses are segments. If one of the campuses issues a separate report, that one campus is not a segment.

Reporting is simple and lies within the footnotes. Three **condensed** financial statements are presented. The statement of net assets will only have current assets, capital assets, current liabilities, long-term liabilities and net assets. The statement of revenues, expenses and changes in net assets will have operating revenues, operating expenses and non-operating revenues. The statement of cash flows will only have the “bottom lines” of a full statement of cash flows.

From the guidance that is available as of the date of this guide, it is evident that the University of Massachusetts Building Authority will remain a separate component unit of the University and not be classified as a segment.

Continued

VII. Footnotes Under Statements 34 and 35

Statements 34 and 35 change footnotes to the financial statements slightly. Certainly the fixed assets and long-term debt footnotes are more meaningful under the new reporting model. It should be noted though, that GASB has been working for years to review, revise and update the note disclosures in governmental financial reporting. The note disclosure project will be in exposure draft form from GASB by **late June of 2000**. The final release of a note disclosure statement should come as early as the **first quarter of 2001**. **Dates of implementation match the implementation of GASB 34 / 35.**

Ongoing current disclosures, absent GASB 34 / 35 must include the following, if applicable:

- Description of your reporting entity
- Description of the items presented and the basis of accounting
- Budgetary data – **NOT REQUIRED BUT POTENTIALLY HELPFUL TO YOUR ENTITY**. If included, report as “other supplementary information.”
- Deficits
- Cash deposits and investments
- Receivables
- Capital Assets
- Restricted Assets
- Payables
- Lease obligations
- Debt
- Pension obligations (not applicable if in the Commonwealth’s system.)
- Post-employment benefits other than pensions
- Restatements of prior years
- Joint ventures
- Related organizations
- Related party transactions
- Contingencies and commitments
- Subsequent events.

A checklist of basic footnotes to meet the minimum standards of GASB 34 and 35 has been included in the appendix. The footnotes are similar to current practice with some modifications to what is listed above. As a general reference to paragraphs in GASB 34 and 35, the table in the appendix lists those required footnote disclosures.

The note disclosure project is focused on a number of major topics in four major areas. The Board is tackling the descriptions of the funds themselves, the aging process of accounts receivable, transfers in and out and inter-fund advances that will not be repaid within a year. In addition, there are ongoing discussions about:

- Deposits and investments
- How component units are disclosed
- Risk management, including custodial credit risk
- Construction and significant commitments
- Components of financial statement balances
- Inter-fund balances and transfers
- Violations of finance-related legal and contractual provisions
- Cash flow.

According to GASB, the exposure draft may be released in the form of an “Omnibus statement” correcting some technical flaws in GASB 34 / 35 and existing note disclosure requirements. Our office will keep you informed once the exposure draft is issued. I encourage you to comment on the exposure draft **to us here at the Office of the Comptroller, so that we may provide a unified response to GASB in this important matter.**

Continued

VIII. Required Supplementary Information

GASB 34 and 35 continues much of the required supplementary information that is currently in place. A major change is that the Management's Discussion and Analysis (see section II) is now required supplementary information and will be audited as such under the aforementioned SAS 52 (AU 558) by your outside auditors. This change will necessitate greater focus on the MD&A, if your institution had previously presented such information.

Other than the Management's Discussion and Analysis, the statements require information on budgets **if your school does NOT follow business type activity accounting, which we are urging you to follow**. The Commonwealth as a whole will have to present budgetary comparison schedules for budgets that are legally adopted. To reiterate, according to Ken Schermann, GASB, unless your school feels it necessary to do so, an institution that follows business type activity accounting, is **not required to present a budget to actual statement**.

a. Additional Information Presented for Purposes of the Board of Higher Education – Other Supplementary Information (OSI)

Traditionally, institutions of higher education in the Commonwealth have presented supplementary schedules within their financial statements for the benefit of the Board of Higher Education. These schedules are presented for the purpose of additional analysis, but are not part of the basic financial statements. The Board of Higher Education reserves the right to amend its policy relating to which funds to present for the purpose of additional analysis.

Your institution should continue to include these supplementary schedules. They include certain funds (e.g. restricted and unrestricted funds, residence halls funds, student government association funds etc.) balance sheets (statements of net assets,) their statements of revenues, expenditures and changes in net assets and reconciliation of MMARS balances to internal institutional accounting system balances.

These items can be presented in the form of a footnote or a schedule.

Continued

IX. The Commonwealth's Single Audit

The Single Audit Act of 1984, as amended, and Office of Management and Budget Circular A-133 require that the Commonwealth conduct a single audit each year. This audit, known as the Statewide Single Audit, includes both the financial statements and compliance with federal requirements. A single audit reviews the entire operations of an entity that expends over \$300,000 in federal assistance, annually. A program review, in contrast, looks only at the operations of a single program. At this time the Commonwealth and the federal government consider all state institutions of higher education (except for the University of Massachusetts, which conducts its own single audit) as included in and covered by the Statewide Single Audit. This coverage exists whether or not auditors have a presence at a given institution in any particular year.

At most state and community colleges the federal Student Financial Aid program is the largest, and often the only, federal financial assistance. The Office of the State Auditor reviews these grants on a rotating basis as part of the single audit. Some institutions prefer their federal program(s) to be audited every year. They then contract with an independent private auditor to perform program reviews, which are then incorporated into the Statewide Single Audit.

The State Board of Higher Education requires an annual financial review of state-funded student financial aid, which is performed for state schools as an *agreed upon procedures engagement*. These agreed-upon procedure engagements may include the federal Student Financial Aid program review. Last year, some higher education institutions decided to use the agreed-upon procedures to contract for trial single audits. The results of these audits were then combined into the Statewide Single Audit. Because of the difference in audit style and the lower materiality levels, one of these institutions received many more findings in the FY1999 Statewide Single Audit than any other department in the state. For this and other reasons we generally try to discourage state and community colleges from arranging for their own single audits.

Separate single audits for institutions of higher education are not specifically forbidden, however. Therefore, we have developed a protocol for departments that wish to arrange for such an audit. A checklist for the protocol is included in the appendix to this implementation guide. Important points in the checklist are as follows:

- ◆ Your institution must submit a letter of intent to the Office of the Comptroller by February 1 of each year, with a complete analysis of cost effectiveness, resources, timelines, and key dates.
- ◆ The financial statement and GAAP package reporting must meet the deadline of August 15th for the three prior fiscal years before proceeding with an independent single audit.
- ◆ The draft A-133 report must be submitted to the Office of the Comptroller by **September 15th; the signed report one month later .**

- ◆ A Federal data collection form must be submitted no later than March 31 of the succeeding year.

To perform a proper single audit separate from the Commonwealth, an intense amount of coordination is needed between your school and the Comptroller's office. A decision to perform the audit cannot be taken lightly. Because an auditor must follow up on all findings, a school cannot perform an audit for a year and then not perform one the next.

Continued

X. Concluding Remarks

The new reporting model presents an exciting opportunity for governments of all sizes and types. Government will become more accountable, with easier to understand financial statements that are more comparable to private entities. For those unprepared, it will be a challenge to implement the provisions of the statements. For others, implementation of GASB 34/ 35 is an opportunity to improve old ways of presentation. Some forward thinking practitioners have said that GASB 34 and 35 are “transition” statements to a more “popular reporting view.” The more popular reporting view – a view easy to understand by the general public-- includes service efforts and accomplishments reporting. For example, the public will want to know how your students are succeeding in comparison to the amount of appropriations and tuition dollars received.

Our common goal is to implement statements 34 and 35 as smoothly as possible in the timeframe specified in the statements. We appreciate your continued support and look forward to working with your institution of higher education to accomplish our common goal.

XI. Appendices

- A. Calendar of Implementation in the Commonwealth
- B. Schedule of Asset Lives –
 - 1. Commonwealth of Massachusetts Operational Services Division
 - 2. Internal Revenue Service Publication 946
- C. Checklist for Components of a Comprehensive Annual Financial Report
- D. Checklist for Components of a Management's Discussion and Analysis under GASB 34 / 35
- E. Checklist for Note Disclosure Items Required by GASB 34 / 35
- F. Checklist for separately conducting a Single Audit from the Commonwealth – wide Single Audit
- G. Statement of Cash Flow Conversion Worksheet – College